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THE REGULATION OF RAILWAY RATES UNDER THE FOURTEENTH AMENDMENT[1]

SUMMARY

I. Early cases, such as the Slaughter House Case and Munn v. Illinois seemed to indicate narrow scope for the 14th Amendment, 389. — II. The Minnesota Rate Cases (1890) put greater restriction on the regulative powers of states, 393. — Dissenting Opinions, 395. — The question of principle directly presented in the Texas Case, Reagan v. Farmers Loan & Trust Co. (1894). The State inhibited, 398. — Other cases, establishing the right of judicial inquiry, 400. — III. The problem of valuation. The Nebraska Rate Cases (1898), 402. — No definite rule stated regarding valuation, 404. — A suggested distinction between public service corporations and those placing their property in an analogous position, 407. — An unremunerative rule sustained in the Minnesota coal case (1902), 410. — IV. What is reasonable value of property? The San Diego Water-rate case, 412. — The Knoxville Water case, 414. — The New York Gas Co. Case, 416. — Rising land value, 417; the valuation of the franchise, 418; the value of a going concern, 419. — The element of wages of superintendence, 421. — The law still in a formative stage as regards reasonable value, 423. — Difficulties from interaction of state and federal regulation, 424.

I

IN 1873 the Supreme Court of the United States, in the first decision[2] that involved the construction of

[1] This paper gives the substance of lectures delivered at Harvard University on the 14th Amendment.

[2] Slaughter House Cases, 16 Wallace, 36

It may not be amiss to quote the language of that part of the first section of the 14th Amendment which is here under consideration

"No state shall make or enforce any law which shall abridge the privileges or

the Fourteenth Amendment, limited its application in a way that must have surprised both those who had advocated and those who had opposed its adoption on the floor of Congress. The court held that the privileges and immunities of citizens of the United States protected by the amendment were not the general privileges and immunities of citizens, but only those special privileges and immunities that belonged to citizens of the United States as such, — the right to come to the seat of government, to assert claims against the national government, to transact business with it, to seek its protection, to share its offices, to have free access to its seaports, subtreasuries, land offices, and the courts of justice of the several states, to demand its care and protection over life, liberty, and property when on the high seas or in the jurisdiction of a foreign government, to assemble and petition for redress of grievances, and to have the writ of habeas corpus; to use the navigable waters of the United States, and to enjoy all rights secured by treaty with foreign nations, to change citizenship from one state to another with the same rights as other citizens of that state. Important as these rights are, they are not the ordinary everyday rights that closely affect the citizen. For these he was left to the protection of the states. Tho the actual decision related only to one clause of the amendment, the opinion of Mr. Justice Miller, who spoke for the court, intimated strongly that the clause forbidding the states to deprive any person of life, liberty, and property without due process of law, and to deny to any person within its jurisdiction the equal protection of the laws, was

immunities of citizens of the United States, nor shall any state deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

The reader need hardly be reminded that this Amendment was made after the Civil War, being ratified in 1868

intended to protect against unjust discrimination the negro race only.

Three years later, however, in the Granger Cases,[1] (1876) it was taken for granted that the scope of the latter clause of the amendment was broader, and that it protected not merely those of the negro race, but all persons. The court in fact followed the dissenting opinions of Justices Field and Bradley, not the dictum of the prevailing opinion of Justice Miller.

The Granger Cases settled the authority of the state legislatures to control the charges of a business affected with a public interest. Some of the language used by the court went far in denying any right of the court to interfere. It was said distinctly that tho the power conceded to the legislature was liable to be abused, the people must resort for protection against abuses to the polls and not to the courts. It was conceded that under some circumstances, but not under all, statutory regulations might deprive the owner of his property without due process of law; but it was held that the amendment did not change the law; "it simply prevents the States from doing that which will operate as such a deprivation."

The question of rates seemed by these decisions determined to be a legislative, not a judicial question. Six years later[2] the court held that a railroad company whose board of directors was by the charter authorized to establish rates could not as against a general law of the state exact more than three cents per mile per passenger. The reasoning was put on a narrow basis, involving only the construction of the charter. The

[1] Munn v. Illinois, 94 U. S 113 [1877] Chicago, B & Q R. R. Co. v. Iowa, 94 U. S. 155. Peik v. Chicago and N W Railway Co., Lawrence v. Same, 94 U. S. 164. Chicago, M. & St. C. R R Co v Ackley, 94 U. S 179 Winona & St. Peter R. R. Co. v. Blake, 94 U. S. 180 Stone v Wisconsin, 94 U. S. 181.

[2] Ruggles v. Illinois, 108 U S 526. [1883]

power granted was to determine the rates by by-laws; the power to pass by-laws was limited to such as were not repugnant to the laws of the state, and hence it was held that the by-laws could not fix a greater rate than was permitted by the general legislation; "grants of immunity from legitimate control," said the Chief Justice, "are never to be presumed."

The states soon began to avail themselves of the power to control business affected with a public interest. The first important case concerning the limitation of their powers arose in California.[1] It decided that the rates of a water company might be fixed by a county board in which the water company was not represented, altho the charter of the company provided for its representation. The court expressly reserved the question what might be done in case the municipal authorities did not exercise an honest judgment or fixed a price manifestly unreasonable. Two years later,[2] it was decided that railroad charges might be fixed by a Railroad Commission, altho charters provided that the companies themselves might fix the tolls and charges. The legislature of Mississippi, by legislation subsequent to the charters, created a Railroad Commission with power to revise rates and increase or reduce them as experience and business operation might show to be just. It was argued that the legislature by the provision in the charters had surrendered the power of control over fares and freights. It was conceded that the rates must by the rule of the common law be reasonable, and the court held that the state was left free to act on the subject of reasonableness within the limits of its general authority as circumstances might require. "The right to fix

[1] Spring Valley Water Works v Schottler, 110 U S. 347. [1884.]

[2] Railroad Commission Cases, 116 U. S 307. [1886.]

reasonable charges has been granted," said Chief Justice Waite, " but the power of declaring what shall be deemed reasonable has not been surrendered. If there had been an intention of surrendering this power, it would have been easy to say so; not having said so, the conclusive presumption is there was no such intention." The court, however, was careful to guard against an inference that the power of regulation was without limit. " The power to regulate," it was said, " is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law."

The statute was held not to be in conflict with the due process clause and the equal protection clause of the Fourteenth Amendment. " General statutes fixing maximum rates," it was said, " do not necessarily deprive the railroad company of its property contrary to the amendment." The importance of the qualifying word " necessarily " appeared in subsequent decisions when it was held that such statutes might sometimes be void. The decisions thus far were in favor of public control, and against review by the courts.

II

Four years later, in the Minnesota Rate Cases,[1] the court took a position hard to reconcile with what was said in *Munn v. Illinois* and the succeeding cases.

[1] Chicago, M & St. P Railway Co v Minnesota, 134 U. S 418. [1890.] Minneapolis Eastern Railway Co v Minnesota, 134 U. S. 467. [1890.]

The Minnesota Commission had ordered a reduction of rates for transportation of milk from three cents to two and a half cents a gallon; and for switching cars from $1.25 and $1.50 per car to $1.00 per car. The railroads resisted and, upon application to the state courts, a mandamus was issued to put in force the rates fixed by the commission. The Supreme Court reversed this action. Justice Blatchford rested the reversal upon the fact that the decision of the railroad commission was made a finality under Minnesota law; he said that the commission could not be regarded as clothed with judicial functions or possessing the machinery of a court of justice. "The question of the reasonableness of a rate of charge for transportation by a railroad company, involving as it does the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for its determination. If the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes place in the absence of an investigation by judicial machinery, it is deprived of the lawful use of its property and thus in substance and effect, of the property itself, without due process of law and in violation of the Constitution of the United States; and in so far as it is thus deprived, while other persons are permitted to receive reasonable profits upon their invested capital, the company is deprived of the equal protection of the laws."

The court seemed by this language to decide that the question of rates was always a judicial question, and not, as had been held before and has been held since, a legislative question; that it could therefore be settled by a judicial tribunal only; that if a railroad company was not allowed to charge reasonable rates,

its constitutional rights were violated; and that it was entitled to reasonable profits in the same sense as other persons not engaged in a public calling. It is difficult to see how the right to profit as individuals not engaged in a public calling can be consistent with the right of the state to regulate the rates of those engaged in such a calling. The opinion, carried to its logical conclusion, would substitute the courts for the commission as final arbiter; and in effect would throw the whole burden of rate making upon the judicial machinery. No wonder the opinion did not command the unanimous voice of the court. Justice Miller concurred in the result, but upon the ground that the commission had applied to the courts to enforce their order; that in substance this was asking the courts to determine that the order was reasonable, and hence the court had the right and duty to inquire into the reasonableness of the tariff of rates.

Justice Bradley, speaking for himself and Justices Gray and Lamar, dissented. He pointed out that the decision practically overruled *Munn v. Illinois* and the railroad cases decided with it; that the question of the reasonableness of a charge, so far from being a judicial question, was preëminently a legislative one involving considerations of policy as well as of remuneration; that in practice it had usually been determined by the legislature by fixing a maximum in the charter of the company or afterwards if there were no binding contract; that the question only became judicial when the legislature enacted simply that rates should be reasonable, thus necessarily submitting the question what was in fact reasonable to the judicial tribunals; but that the legislature might itself or by its commission fix the rates; and that for that purpose their decision was final, unless they so acted as to

deprive parties of their property without due process of law; but that a mere difference of judgment as to amount between the commission and the companies without any indication of intent on the part of the commission to do injustice, did not amount to a deprivation of property. The real difference between Justice Blatchford and Justice Bradley was as to the question presented in a rate case. According to the former it was: " is the rate a reasonable one, and such as would afford the same profit as could be realized by one not subject to regulation?" According to the latter it was: " is the rate so unreasonable as to be arbitrary and amount to confiscation of property rather than mere regulation of a rate?" The difference is striking and fundamental. If the legislature had the right to regulate rates, as had been settled in the Granger cases, then the property of the railroads was qualified by that public right, and there could be no deprivation of such qualified property as long as the legislature confined itself to fair regulation and did not undertake to confiscate under the guise of regulation. The view of the minority has finally prevailed.[1]

Justice Bradley in the course of his opinion took occasion to speak of the relations between the courts and the legislature. His words are worth quoting: " It is always a delicate thing for the courts to make an issue with the legislative department of the government, and they should never do so if it is possible to avoid it. By the decision now made we declare, in effect, that the judiciary, and not the legislature is the final arbiter in the regulation of fares and freights of railroads and the charges of other public accommodations. It is an assumption of authority on the part of the judiciary, which, it seems to me, with all

[1] Atlantic Coast Line v. No Car. Corp Comm, 206 U. S. 1. [1907]

due deference to the judgment of my brethren, it has no right to make."

The decision of the court in the Minnesota Rate Cases, it was further pointed out, gave a new extension to the meaning of the words "due process of law." Justice Blatchford's language must mean that due process of law requires judicial procedure "with the forms and machinery," to quote his language, "provided by the widsom of successive ages for the investigation judicially of the truth of a matter in controversy." Long before this decision the court had held in an elaborate opinion by Mr. Justice Curtis[1] that the same words in the Fifth Amendment did not necessarily imply a regular proceeding in a court of justice or after the manner of such courts; and this view had been adopted and applied in the construction of the Fourteenth Amendment. The difficulty of Mr. Justice Blatchford's view becomes apparent if it is applied to the taking of the property of the citizen by taxation, by assessments for public improvements, or by administrative measures under the police power; or to restraint of the person made necessary by our immigration laws. "In judging what is due process of law," said Mr. Justice Bradley, "respect must be had to the cause and object of the taking, whether under the taxing power, the power of eminent domain, or the power of assessment for local improvements, or none of these: and if found to be suitable or admissible in the special case, it will be adjudged to be due process of law; but if found to be arbitrary, oppressive and unjust, it may be declared to be not 'due process of law.'"

The decision in the Minnesota Rate Case inevitably led to repeated efforts to secure review by the courts

[1] Murray's Lessee v Hoboken Land and Improvement Co , 18 How. 272 [1856]

of rates fixed by statute or the orders of public commissions.

After an unsuccessful effort by a friendly litigation to have a particular rate declared unreasonable,[1] the question next arose in the great case of *Reagan v. Farmers Loan & Trust Co.*,[2] noteworthy because it was the first successful effort to enjoin the enforcement of rates fixed by a commission.

The question was squarely raised, for the defendant denied the power of the court to entertain the inquiry at all, and insisted that the fixing of rates for carriage by a public carrier was a matter wholly within the power of the legislative department of the government and beyond examination by the courts. To this the court through Mr. Justice Brewer answered: "The province of the courts is not changed, nor the limit of judicial inquiry altered, because the legislature instead of the carrier prescribes the rates. The courts are not authorized to revise or change the body of rates imposed by a legislature or a commission; they do not determine whether one rate is preferable to another, or what under all circumstances would be fair and reasonable as between the carriers and the shippers; they do not engage in any mere administrative work; but still there can be no doubt of their power and duty to inquire whether a body of rates prescribed by a legislature or a commission is unjust and unreasonable, and such as to work a practical destruction to rights of property, and if found so to be, to restrain its operation."

The complainants challenged the tariff as a whole and the court's inquiry was limited to its effect as a whole. The facts were thus stated by the court:

[1] Chicago & Grand Trunk Railway Co v Wellman, 143 U. S. 339. [1892]

[2] 154 U. S 362 [1894]

The cost of this railroad property was $40,000,000; it cannot be replaced to-day for less than $25,000,000. There are $15,000,000 of mortgage bonds outstanding against it, and nearly $10,000,000 of stock. These bonds and stock represent money invested in the construction of this road. The owners of the stock have never received a dollar's worth of dividends in return for their investment. The road was thrown into the hands of a receiver for default in payment of the interest on the bonds. The earnings for the last three years prior to the establishment of these rates were insufficient to pay the operating expenses and the interest on the bonds. In order to make good the deficiency in interest the stockholders have put their hands in their pockets and advanced over a million of dollars. The supplies for the road have been purchased at as cheap a rate as possible. The officers and employes have been paid no more than is necessary to secure men of the skill and knowledge requisite to suitable operation of the road. . . . The actual reduction by virtue of this tariff in the receipts during the six or eight months that it has been enforced amounts to over $150,000.

Upon these facts the Court said:

A general averment in a bill that a tariff as established is unjust and unreasonable, is supported by the admitted facts that the road cost far more than the amount of the stock and bonds outstanding; that such stock and bonds represent money invested in its construction; that there has been no waste or mismanagement in the construction or operation; that supplies and labor have been purchased at the lowest possible price consistent with the successful operation of the road; that the rates voluntarily fixed by the company have been for ten years steadily decreasing until the aggregate decrease has been more than fifty per cent; that under the rates thus voluntarily established, the stock, which represents two-fifths of the value, has never received anything in the way of dividends, and that for the last three years the earnings above operating expenses have been insufficient to pay the interest on the bonded debt, and that the proposed tariff, as enforced, will so diminish the earnings that they will not be able to pay one-half the interest on the bonded debt above the operating expenses; and that such an averment so supported, will, in the absence of any satisfactory showing to the contrary, sustain a finding that the proposed tariff is unjust and unreasonable, and a decree reversing it being put in force.

In deciding whether a tariff is so unreasonable and unjust as practically to destroy the value of the carrier's property, it is of course essential to fix the standard or principle upon which that value is to be determined.

Upon this question the Reagan case is indecisive. Some of the language suggests that cost of the property is the proper measure of its value; other language, cost of replacement; and still other language, present value. The question was left for discussion in the later cases.

The Reagan case had dealt with the effect of the tariff of rates as a whole. Similar questions arose in *St. Louis and San Francisco Railway v. Gill*,[1] where it was decided that the correct test was the effect of the rates on the whole line of the carrier's road, and not the effect upon that portion which was formerly a part of one of the consolidating roads; that a company cannot claim the right to earn a net profit for every mile of road, nor attack as unjust a regulation which fixes a rate at which some part would be unremunerative; that the earnings of the entire line must be estimated as against all its legitimate expenses under the operation of the act within the limits of the State. The last qualification presents a new difficulty, — that of severing a railroad into parts divided by the imaginary state lines. The later effort to segregate intrastate and interstate business has led to difficult problems still in process of solution. The Gill case was a suit for a penalty, and the court in referring to Justice Miller's statement in the Minnesota Rate cases that the rates were binding until judicially determined to be void, added that in cases where the legislature itself fixed the rates, a bill in equity was impracticable because there was no public functionary or commission which could be made to respond, and the companies, if they were to have any relief, must have the right to raise the question by way of defense to an action for penalties. This remark was unneces-

[1] 156 U. S. 649. [1895.]

sary to the decision, since the result of the case on the facts was against the carrier. The remedy by injunction to restrain legal officers of the state from prosecuting, came later.

The same principle that applies to the case of a carrier, applies also to a turnpike company. In *Covington, etc., Turnpike Company v. Sandford*,[1] the court held that the facts that the tolls for several years prior to 1890 had not admitted of dividends greater than 4 per cent on the par value of the stock; that the proposed reduction would so diminish the income of the company that it could not maintain its road, meet its ordinary expenses, and earn any dividends whatever for stockholders, showed that the constitutional rights of the turnpike company were violated. Justice Harlan was careful to say that a mere failure of the rates to suffice to earn four per cent on the stock would not justify holding the rates to be void. "It cannot be said," he added, "that a corporation is entitled, as of right, and without reference to the interests of the public, to realize a given per cent upon its capital stock. . . . The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends." In dealing with the question how the reasonableness of rates was to be ascertained, the court was not very satisfactory. The inquiry was said to involve a consideration of the right of the public to use the road on paying reasonable tolls, and also of the reasonable cost of maintaining the road in good condition for public use, and the amount that may have been really and necessarily invested in the enterprise. It was held that there might be other circumstances, not then necessary to state; that each case must depend upon

[1] 164 U. S. 578. [1896.]

its special facts; and justice might require different rates for different roads. In short, the opinion merely holds that rates must be reasonable and fair both to the public and the company and must not be so low as practically to deprive the company of its property. No standard was fixed, and the case decided only that the particular rates infringed the constitutional provision. The language of the court indicates that it is the actual and necessary investment of the company that is to be considered. This seems to mean the actual necessary cost as distinguished from cost of replacement or present value.

The results reached up to this point may be thus summarized. State enactments or regulations establishing rates that will not permit of the carrier earning such compensation as under all the circumstances is just to it and the public, infringe the provisions of the Fourteenth Amendment; and the question whether rates are so unreasonably low as to deprive the carrier of its property cannot be conclusively determined by the legislative authority of the state, but may be the subject of judicial inquiry.

III

These general principles do not go far to solve the question in a particular case. The decision in the Nebraska Maximum Rate Cases [1] took a further step. It was contended on behalf of the State that the compensation to be allowed the carrier after payment of operating expenses was purely a question of public policy to be determined by the legislature and not by the courts. "It cannot be successfully contended," said counsel for the State, "that so long as the rate

[1] Smyth v Ames. Smyth v. Smith Smyth v. Higginson, 169 U. S 466 [1898.]

fixed pays something above operating expenses to the corporation for the carrying of property, it amounts to the taking either of the use or of the property." "It must follow then, that, so long as the rate fixed by the law will pay the operating expenses when economically administered, and something in addition thereto, the power of the court ends, and the extent to which rates must produce profits is one of political policy." In short, the contention was that the right of property in a railroad consisted in the title and possession and the privilege to operate it economically, with the right to such additional compensation, however small, as the legislature chose to allow from time to time. The successful maintenance of this proposition would plainly have ended the control of the courts over the subject. It went to the very root of the matter. It might logically be contended that a property right that was subject to legislative regulation, as settled by the Granger Cases, was not taken away when the legislature did in fact regulate; but it was nevertheless true that the power to regulate was not a power to destroy. The case involved really a definition of the word "property" as applied to a common carrier; and in view of the earlier decisions, the court very naturally answered the contention of counsel by saying:

> The idea that any legislature, State or Federal, can conclusively determine for the people and for the courts that what it enacts in the form of law, or what it authorizes its agents to do, is consistent with the fundamental law, is in opposition to the theory of our institutions. The duty rests upon all courts, Federal and State, when their jurisdiction is properly invoked, to see to it that no right secured by the supreme law of the land is impaired or destroyed by legislation. This function and duty of the judiciary distinguishes the American system from all other systems of government. The perpetuity of our institutions and the liberty which is enjoyed under them depend, in no small degree, upon the power

given the judiciary to declare null and void all legislation that is clearly repugnant to the supreme law of the land.

The definition of "property" becomes, therefore, in the last resort a matter for the courts.

The Nebraska case involved also the question of rates within a state over railroads extending through other states. It was said that rates reasonable in Iowa might be unreasonable in Nebraska since the density of population, and hence of traffic, might be greater in the former, while the cost of construction and maintenance might be less. It was held that the reasonableness of rates on traffic wholly within the state must be determined without reference to the interstate business done by the carrier or to the profits derived from it. "The argument that a railroad line is an entirety; that its income goes into, and its expenses are provided for out of a common fund, and that its capitalization is on its entire line, within and without the state, can have no application where the State is without authority over rates on the entire line, and can only deal with local rates and make such regulations as are necessary to give just compensation on local business." Whether the attempt thus made to sever the intrastate from the interstate business can be carried out successfully is a question involved in later litigation and not yet settled. It involves a determination of the proportion of value of plant and cost of traffic to be attributed to the lines within the state. In view of the interaction of the various elements of cost and of revenue within and without the state upon each other, the problem is most difficult, and may prove possible of solution only by an approximation.

The Court in the Nebraska case considered also the question on what amount the railroads were en-

titled to earn a revenue. The companies contended that they were entitled to such rates as would enable them at all times, not only to pay operating expenses, but also to meet the interest regularly accruing upon all outstanding obligations and to justify a dividend on all their stock; less than that, it was said, would deprive them of property without due process of law. The court held, however, that this contention practically excluded from consideration the fair value of the property used, omitted the right of the public to be exempt from unreasonable exactions, would justify the railroad in trying to earn interest on bonds in excess of its fair value and dividends on fictitious capitalization. The court was still indefinite in laying down the basis of the valuation on which earnings might fairly be had. It said the rights of the public would be ignored if rates were exacted without reference to the fair value of the property used for the public or the fair value of the services rendered. But these two bases of calculation are far from leading to the same result. To base rates upon the value of the property, involves the value of the plant in its entirety and the net result of all the rates on thousands of items. To base them upon the value of the services rendered, involves a consideration only of particular items and may involve a consideration of the value of the services to the shipper. The two methods are incommensurate. What the Court decided was that the basis of all calculations as to the reasonableness of rates must be the fair value of the property used; that in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of the bonds and stock, the present as compared with the original cost of construction, the probable earning

capacity of the property under the particular rates prescribed, and the sum required to meet operating expenses, are all matters for consideration, to be given such weight as may be just and right in each case. Justice Harlan was careful to add: "We do not say that there may not be other matters to be regarded in estimating the value of the property."

Many of these elements required and have received and are destined to receive further definition and analysis. What other elements are to be considered may never be finally settled, so infinitely various are the circumstances that distinguish each case as it arises.

The court soon had occasion to apply the rule, and the opinion shows no greater certainty in the basis of valuation.[1] A water company insisted that the court should consider the cost of the plant, the annual cost of operation including interest on money borrowed and reasonably necessary to be used in constructing the same; the annual depreciation of the plant from natural causes resulting from its use; and a fair profit to the company either by way of interest on the money expended for the public use, or upon some other fair and equitable basis. All these matters the court conceded ought to be taken into consideration, but it held that the basis of calculation was defective in not requiring the real value of the property and the fair value in themselves of the services rendered to be taken into consideration. The opinion, however, points to no more definite rule. "What the company is entitled to demand," says the court, "in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public." This adopts present value

[1] San Diego Land Co. v. National City, 174 U S. 739. [1899.]

as the standard, but leaves unsettled how the reasonable value of the property is to be ascertained, and what is a fair return.

The opinion in the next case[1] sought to make a distinction between public service companies and companies which without any intent of public service have placed their property in such a position that the public has an interest in its use. As to the first class, Justice Brewer said the owner intentionally devoted his property to the discharge of a public service, and undertook that which is a proper work for the State, and might be said to accept voluntarily all the conditions of public service which attach to like service performed by the State itself. As to the second class the owner placed his property in such a position willingly or unwillingly, that the public acquire an interest in its use, but he submits only to those necessary interferences and regulations which the public interests require. Of the former it was said that since the State was not guided solely by a question of profit but might conduct the business at a loss having in view a larger general interest, so perhaps an individual who had shown his willingness to undertake the work of the State might be held to perform that service without profit. The suggestion was put in the form of an interrogation, since it was confessedly unnecessary in the pending case to determine the question. It seems to conflict with *Smyth v. Ames*, and the court has never yet decided that the legal right of regulation goes to this extent. The decided case involves a corporation of the other class, which was not doing the work of the State, was not performing a public service, and had acquired from the State none of its governmental powers. The business was that of a

[1] Cotting v Kansas City Stock Yards Co., 183 U S 79. [1901.]

stock yard at Kansas City. The business was held to be so affected with a public interest, being at the gateway of a great commerce of which it was an important if not a necessary adjunct, that its charges like those of a grain elevator were subject to public regulation. But the court said the "business in all matters of purchase and sale is subject to the ordinary conditions of the market and the freedom of contract. He (the owner) can force no one to sell to him, he cannot prescribe the price which he shall pay. . . . If under such circumstances he is bound by all the conditions of ordinary mercantile transactions, he may justly claim some of the privileges which attach to those engaged in such transactions. And while he cannot claim immunity from all state regulation, he may rightfully say that such regulation shall not operate to deprive him of the ordinary privileges of others engaged in mercantile business." The difference in practical result suggested in the opinion is that in the case of a business affected with a public interest altho not devoted to the public service, the state's regulation of charges is not to be measured by the aggregate of profits determined by the volume of business, but by the question whether any particular charge to an individual dealing with him is, considering the service rendered, an unreasonable exaction. "The question is not how much he makes out of his volume of business, but whether in each particular transaction the charge is an unreasonable exaction for the services rendered. He has a right to do business. He has a right to charge for each separate service that which is reasonable compensation therefor, and the legislature may not deny him such reasonable compensation, and may not interfere simply because out of the multitude of his transactions the amount of his profits

is large. Such was the rule of the common law even in respect to those engaged in a quasi public service independent of legislative action. In any action to recover for an excessive charge, prior to all legislative action, who ever knew of an inquiry as to the amount of the total profits of the party making the charge ? "

The distinction suggested by Justice Brewer and his expressions with reference to the subject are interesting and suggestive; but the opinion was not the opinion of the court. Six out of nine judges assented to the judgment upon the ground that the Kansas statute violated the Fourteenth Amendment because it applied only to one stock-yards company, and not to other corporations engaged in like business in Kansas, and therefore denied to that company the equal protection of the laws. They were careful to say that they expressed no opinion upon the question whether it deprived the company of its property without due process of law. This, and not Justice Brewer's elaborate opinion, expresses the view of the court. Under the facts of the case it amounted to saying that the answer was doubtful to the question whether rates that enabled a company to earn 5.3 per cent on the value of the property used for stock-yards purposes, instead of about 10 per cent previously earned, amounted to depriving it of property without due process of law; the propriety of any rate of return was not decided.

The suggestion that a public service company, doing the work of the state, might properly do it for an unremunerative rate bore fruit in the Minnesota Coal Rate case.[1] That case is important because it sustained an unremunerative rate upon coal fixed by the state commission. The ruling is in conflict with the reasoning of *Smyth v. Ames* (the Nebraska

[1] Minneapolis & St. Louis R'd Co. v. Minnesota, 186 U. S. 257 [1902.]

cases) and the court recognizes the necessity of explaining the distinction. It says that while the reasonableness or unreasonableness of rates for intrastate traffic must be determined without reference to the interstate business, it does not follow that the companies are entitled to earn the same percentage of profits on all classes of freight carried. This hardly justifies the conclusion that the carrier may be compelled to carry some goods at a loss; for if so, the power to select those goods involves a power to discriminate quite at variance with fundamental principles; if the railroad can be compelled to carry coal at a loss, it may also be compelled to carry other goods at a loss; and since it is entitled to a fair return upon the whole business, this loss must be made up by the imposition of a heavier rate on other goods than would naturally fall thereon; the public authorities are then permitted to discriminate against some shippers and in favor of others, a discrimination which has always been condemned, and was held to be illegal by the New Jersey Supreme Court,[1] upon the ground that carriers were engaged in a public employment, three years before the United States Supreme Court decided the Granger Cases.

The court in the Minnesota Coal Rate Case sought to justify the losing rate upon the ground that for purposes of ultimate profit and of building up a future trade, railways carry both freight and passengers at a positive loss. No doubt such is the fact, and if railways were to be left free to fix rates according to their own pleasure, and to discriminate at their pleasure between shippers, the practice of sowing seed to reap a future crop might be permissible. The difficulty is that considerations of that kind are not reducible to a legal rule, but involve considerations of business policy.

[1] Messenger v Pennsylvania R R 700, 407. [1873]

It is not only difficult to determine how much of the value of an entire railroad shall be attributed to the portion within a state, but since even that portion is used in part for intrastate and in part for interstate traffic, the value of the property used for local and for through traffic must also be determined; and since all the business is done by the same men, with the same equipment, the total cost of conducting the business must also be apportioned. As might be expected from the intricacy of the problem, the results thus far reached are not satisfactory. In the Gill case it was held that every mile need not pay; from which it would seem to result that the system must be treated as an entirety, and that losses on local traffic might be balanced by profit on through traffic or vice versa. *Smyth v. Ames* decided the contrary, and made necessary the determination of the proper basis for apportionment of value and cost. The South Dakota case [1] rejected gross receipts as a proper basis for the apportionment. The other basis suggested is that of the volume of traffic determined according to ton mileage. The tendency of the more recent cases in the lower federal courts seems to be in the direction of apportioning cost and value according to gross receipts. The question is still unsettled in the Supreme Court. In the Florida Phosphate cases,[2] the court leaned to the ton mile basis, at least as far as concerns the cost of doing the business.

The question to be decided when the protection of the Fourteenth Amendment is invoked, is whether the rates as a whole afford a sufficient return, or are so low as to amount to confiscation. When, as in the

[1] Chicago, M. & St. P. R'y v Tompkins. 176 U S 167

[2] Atlantic Coast Line v Florida, 203 U S 256 [1906.] Seaboard Air Line v Florida, 203 U S 261. [1906]

South Dakota Coal case or the Florida Phosphate cases, the rate upon a single article only is involved, it is impossible to determine the effect of that single rate upon gross or net returns on the entire traffic, and hence impossible to prove that the rate fixed is so low as to amount to confiscation. Such was the result in the Florida Phosphate cases, and it is quite conceivable that the court might be forced to decide that one unremunerative rate after another was not in conflict with the property right of the carrier, until an entire schedule of unremunerative rates might have been sustained. In the Phosphate cases the question did not arise, since the rate permitted exceeded the average receipts per ton per mile under the previous tariff. But the possibility of the result I have indicated illustrates the danger of the decision in the Minnesota Coal case, that a carrier may be required to carry a particular commodity at an unremunerative rate.

IV

The reasonable value of the property used was by 1903 pretty well recognized as the proper standard upon which returns may be earned. In *San Diego Land & Town Co. v. Jasper* [1] the court said: "It no longer is open to dispute that under the Constitution what the company is entitled to demand, in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public." That standard is adopted as against a standard based on actual cost, less depreciation. Actual cost, selling price, valuation for taxation, may all be evidence of the actual value. But actual value may sometimes be enhanced by the

[1] 189 U S 439. [1903]

fact that the plant is larger than is needed. Is the company entitled to earn a revenue on an unnecessary expenditure? To this question, the court answers, no. Upon the value as fixed by the local board, rates were fixed with the intention of securing a yield of 6 per cent. The court found no sufficient evidence that this rate was confiscatory. But the local board had fixed the rates as if the water company supplied the whole 6000 acres outside the city for which the works were intended. In fact it supplied less, and its receipts were therefore less than the supervisors estimated. The result might give the appellant less than 6 per cent on the value of the plant. But the court said that if the plant was built for a larger area than it could supply, the Constitution did not require that two-thirds of the contemplated area should pay a full return. The case is therefore important because it holds that a failure to pay 6 per cent on present value is not necessarily decisive of the question whether rates are confiscatory so as to violate the constitutional provision. The present value on which the company is entitled to a return is only the present value of what is reasonably necessary for the public service.

A water company in California [1] was incorporated under a statute which empowered the county board of supervisors to regulate rates, but not to reduce them so low as to yield to stockholders less than 1½ per cent a month on the capital actually invested. After the company had invested about a million dollars in its plant, a new statute empowered the supervisors to so adjust the rates as to yield not less than 6 nor more than 18 per cent per annum upon the value of the property actually used and useful

[1] Stanislaus County v. San Joaquin and King's River Canal and Irrigation Co. 192 U S 201. [1904]

for the supply of water. The court held that there was no contract the obligation of which was impaired, and that even if there was a contract, the legislature might alter or amend the original statute under its reserved power. For our present purpose the important point decided is that it is not a confiscation nor a taking of property without due process, nor a denial of the equal protection of the laws, to fix water rates so as to give an income of six per cent upon the then value of the property actually used, even tho the company had prior thereto been allowed to fix rates that would secure to it 18 per cent upon the capital actually invested. The right of property of a water company under the California statute, so far as it is protected by the Fourteenth Amendment, is no more than a right to earn 6 per cent on present value, regardless of actual investment or previous statutory provisions permitting a larger return.

The method of determining present value still remains to be settled. To ascertain the value of tangible property, such as lands or buildings, for the purpose of determining the just compensation required to be made when it is taken for public use, has always been a sufficiently difficult question. To ascertain the value for the purpose of determining whether a schedule of rates is confiscatory is more difficult still.

In the Knoxville Water Company case,[1] the value had been based on cost of reproduction, to which there was added $10,000 for organization and promotion expenses, and $60,000 for value as a going concern. The court declined to decide upon the propriety of including these two items in the estimate, and expressly reserved them for consideration when the question necessarily arose. The Knoxville case turned

[1] Knoxville v Water Co., 212 U. S. 1. [1909.]

upon the failure of the court below to make a proper deduction for depreciation arising from age and use. It was held that the water company was not entitled to value an old plant as if it were a new one. The more interesting question was as to the right of the company to add to the present value of its plant the cost of what had been lost through destruction or obsolescence, and what had been impaired in value altho still in use. There was little discussion of the question in the opinion, no doubt because the circumstances of the particular case did not call for discussion. The court held that it was the duty of the company to use enough of its earnings to keep its plant good, before coming to the question of the amount of its profits, and that if it failed to keep its investment unimpaired, whether because it declared unwarranted dividends on over-issues of securities, or because it failed to exact proper prices for its output, it could not enhance the present value of its property by the addition of the costs of its mistakes. The question is likely to arise, as it has already in some cases, in a more difficult form, where fruitless but necessary experiments have been made, or plant has become obsolete in a rapidly advancing industry before it could possibly be made good out of current earnings. It arose before the Interstate Commerce Commission, in the converse case where the corporation, in order to reduce its apparent rate of earnings, sought to charge against current earnings the cost of betterments from which it was likely to profit for years to come. The Supreme Court approved the ruling of the Interstate Commerce Commission and held that the instrumentalities that are to be used for years should not be paid for by the revenues of a day or year.[1] A public

[1] Illinois Cent. R R v Inter. Com Comm. 206 U. S. 441. [1907]

service company cannot use more money in a year than is required for actual depreciation, and carry the excess as an addition to capital for the purpose of estimating the amount on which it is entitled to dividends, in determining whether a rate is confiscatory.[1] Novel questions of this character will arise with increasing frequency, and require the most careful consideration. Like most other questions in every department of the law, they are in their origin rather questions of fact than questions of law, altho in course of time the rules become settled and thus become rules of law. In their origin, and as yet, many questions are questions of sound business management and engineering science. The law prescribes reasonable returns upon a reasonable valuation. What is a reasonable return and what is a reasonable valuation must vary with the circumstances of each particular case.

The basis of present value adopted in the Knoxville Water Company case was cost of reproduction less an allowance for depreciation in order to make up the difference between the value of new and old. Such a basis in the case of land, especially in a growing city, tends to make the cost of reproduction exceed the original cost, and in the case of railroads especially is almost sure to make present value greatly in excess of cost to the companies. It has therefore been contended with much ingenuity and force that the basis for rate regulation should not exceed the capital actually invested. In *Willcox v. Consolidated Gas Co.*,[2] it was argued that one gas company should not be permitted to charge more than another for the sole reason that movements of population, uninfluenced by either

[1] Louisiana R. R Comm. v Cumberland Tel Co , 212 U S. 414 [1909]

[2] 212 U. S 19. [1909.]

company, had caused the site of its plant to be more valuable if vacated and sold; for it was said that altho the fortunate company was entitled to obtain the full value of the land when sold, the unrealized profit meanwhile did not represent profit used in the manufacture and distribution of gas, but rather represented wealth which the manufacture and distribution of gas keeps out of use. This argument seems sound. The circumstances of the case did not call for an answer by the court. It did, however, distinctly reject the basis of actual cost even in the case of land. It held that the value of the property must be determined as of the time when the inquiry was made regarding rates; that the company was entitled to the benefit of any increase of value. That is in harmony with the general rule of law which permits the owner of real estate to profit by any increase in the value of his land. Obviously, however, if we are to uphold the rule that a public service corporation is entitled only to a reasonable return and that the public are entitled to be served at reasonable rates, we must apply the rule of reasonableness to the amount of the investment, as was done in the San Diego Water case. The court recognized this, for it said there might be an exception to the rule where the property had increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public. This makes the reasonableness of the amount allowed for value of the property depend on the reasonableness of the rate to the public; but since the rate must afford a reasonable return to the company also, we are at once reasoning in a circle. The basis suggested by Mr. Whitney, in his argument as counsel, seems a better one, — that the value allowed should be the estimated cost

of replacing the land in use with other land capable of accomplishing the same result. Probably no one would contend that if a gas company had been so fortunate as to locate its works at the corner of Broad and Wall Streets, and its land had attained the enormous value that there prevails, it should be entitled to a return from its gas sales on the present value of the site. Prudent management would require removal to a less expensive site better adapted for the business.

The more difficult question that arose in the Gas Company case was the valuation of the franchise. As to the general question of the propriety of including the value of the franchise in the valuation of the property, the opinion gives little light. All that was decided was that it was proper to include in the valuation, the value attributed with the consent of the state to the franchises at the time of the consolidation of the companies, upon which investors had relied; and that it was wrong to hold, as the court of first instance did, that the value of the franchise had increased in the same ratio as the value of the tangible property. When it came to the general question, the court said that to allow for increased value of the franchise was too much a matter of pure speculation and also opposed to the principle upon which such valuation should be made. Whether the court meant merely that the evidence in the particular case was not sufficiently certain to justify the increased valuation, or whether it meant that upon principle the valuation of the franchise ought not under ordinary circumstances to be included, the opinion leaves in doubt.

The court calls attention to the fact that the franchise was subject to the legislative right to so regulate the price of gas as to permit no more than a fair return upon the reasonable value of the property. It would

have been but a step to hold that to base the return to the company upon the value of such a franchise would be impossible, since the value of the franchise in turn depended on the rates. The two being dependent, one on the other, neither could furnish a substantial basis for fixing the other. As Judge Savage well said in a case in Maine [1] " to say that the reasonableness of rates depends upon the fair value of the property used and that the fair value of the property used depends upon the rates which may be reasonably charged seems to be arguing in a circle." There is, however, as he points out, a sense in which the value of the franchise must be considered. It is the franchise, the right to operate and if possible to earn a dividend, that makes the difference between a lot of junk, — old rails, pipes, and the like, — not worth recovering from their situation in and upon the ground, and a completed plant, railroad, water works, gas works, as the case may be. This is a part of the value of a going concern, the allowance for which the court refused to pass upon in the Knoxville Water Co. case. Even tho the franchise is revocable, the fact that the plant has a legal right to exist gives added value to the physical structures. The value of a rightfully existing structure which may be lawfully used is very different from the value of the same structure without the legal right to use it for the purpose for which it was assembled. Quite recently, in the valuation of the Omaha Water Works,[2] the court has expressly approved an appraisal of the value as a going concern. " The difference between a dead plant and a live one," said Justice Lurton, " is a real value, and is independent of any franchise to

[1] Brunswick & T. Water District v Maine Water Co , 59 Atl Rep 537. [1904.]

[2] Omaha v. Omaha Water Co., 218 U. S. 180. [1910.]

go on, or any mere good will as between such a plant and its customers."

Altho ordinarily the value of a franchise is not enhanced by the prospective profit from any particular schedule of rates, there is an exception where by reason of a contract protected by the contract clause of the federal constitution, the corporation may continue to charge specified rates for a definite time.[1] The courts insist on finding the elements of a contract as they would between individuals. There must be an agreement upon sufficient consideration. Where the contract is made by a municipality, there must be legislative authority in the municipality to make the contract; and such legislation is construed strictly in favor of the public; authority to fix and determine rates does not authorize a municipality to make a bargain by which it ties itself up for the future.[2] Another exception may be suggested, — the investment by present owners in reliance upon the continuance or value of the franchise. To what extent, if at all, this element may enter into the calculation has not been expressly decided, nor does the Gas Company case settle the question. It settles indeed that under some circumstances such allowance must be made; but no attempt is made to define the circumstances with precision.

[1] Los Angeles v Los Angeles City Water Co , 177 U S 558 (1900), Detroit v Detroit Citizens Street Railway Co , 184 U. S 368, Cleveland v Cleveland City Ry. Co , 194 U S 517 (1904), Cleveland v Cleveland Electric Railway Co , 201 U S 529 (1906), Vicksburg v Vicksburg Water Works Co , 206 U S. 496 (1907). See also New Orleans Water Works Co v. Rivers, 115 U S. 674 (1885); (sustaining an exclusive right to supply water), New Orleans Gas Co v Louisiana Light Co , 115 U S. 650 (1885), (sustaining an exclusive right to supply gas), Walla Walla v. Walla Walla Water Co , 172 U. S 1 (1898).

[2] Freeport Water Co. v Freeport City, 180 U. S 587 (1901), Danville Water Co. v. Danville City, 180 U S 619 (1901), Rogers Park Water Co. v. Fergus, 180 U. S. 624 (1901), Knoxville Water Co v Knoxville, 189 U S 434; Home Telephone Co. v. Los Angeles, 211 U S 265 (1908).

The court held that the Gas Company case was not one for the valuation of good will because the complainant had a monopoly in fact and the consumer must take gas from it or go without; he must resort to the old stand whether he would or no. The court held also that there was no particular rate of compensation which must in all cases and in all parts of the country be regarded as sufficient for capital invested in business enterprises; the amount of risk, the locality where the business is conducted, the rate expected and usually realized there upon investments similar in character, were all mentioned as factors, and it was held that under the circumstances of the gas business in the City of New York, six per cent was a proper return.

The element of wages of superintendence, which Mr. Whitney in his argument conceded must be covered by the returns to the company, was left out. In one sense this is not a return upon capital but wages of labor, and if it were possible for earnings due to the skill with which the business is managed to be secured to those alone whose skill produced the result, perhaps no more need be said. Practically, however, the earnings depend in part, sometimes in large part, not upon the skill in actual present-day management, but upon the satisfaction with which the public has been served in the past, perhaps by men long since dead. Given equal and reasonable rates, one company will be able to earn large dividends, and another perhaps unable to pay its way; and this result may be due not to any less efficient management, but merely to the fact that one has been long in satisfactory operation while the other is new and not yet in vogue. The greater earnings of the one may even be due to the mere caprice of fashion. But to whatever

cause it is due, difficulty will arise unless allowance be made, either by increasing the capital valuation on which the company is permitted to earn a return, by way of a valuation of a going concern or the value of the probability of an already assured income, or else by allowing an additional return on the valuation minus this increment, by way of extra compensation for the greater skill or the greater satisfaction with which it serves the public. Even in the case of so close a monopoly as the Gas Company in New York City, it is not impossible that some of its earnings may have been due to this cause; for altho it had a monopoly of the supply of gas through pipes in the streets, it may have had competition, in the supply of light, heat, and power, from the electric companies. Altho legally permissible, it would often be impracticable to cut down rates to a level that would afford a fair return to one company upon a valuation that failed to take into account the element of value of a going concern or an assured income, without ruining its weaker competitor. In some cases such lowering of rates would prove inadvisable, especially in the case of railroads. One road may through fortunate investments, the discovery of valuable minerals along its route, the opening of fertile territory, and a rapid increase of population, prove a highly profitable investment; another at the same rates may barely pay its way; yet to cut down rates on the prosperous road so as to reduce its high dividends to a normal level, would emphasize and accentuate the advantage already possessed by those along its line over those along the line of the less prosperous road. Either the prosperous road must be allowed to earn a higher return upon the valuation or the valuation must allow for these elements.

Up to the present time, the United States Supreme Court has not been called upon to decide what elements are proper to be considered in determining the present value of a plant of a public service company. That the value of the plant as a going concern, not only ready for business but with business actually established, is greater than the bare cost of reproduction of the physical plant, is recognized by cases in other courts. It must be so, leaving out of view altogether the element of good will, which in the case of a strict monopoly ought to be disregarded. A going concern has necessarily expended money in various ways aside from the cost of physical plant in order to get going. The cost of promotion of the enterprise, of corporate organization, of obtaining the necessary franchises, permissions, and consents, of securing the necessary connections with other companies by rail or wire; the cost of experiments necessary in every new industry, and the often rapid substitution of improved appliances before the cost of the old can have been recouped out of earnings; the cost of developing the business including the oft-times necessary loss attending the incomplete stage of the plant, or the introduction of new appliances and methods; the cost of financing the enterprise, including interest on capital sunk before any returns begin to come in, — all go to make up the cost of a complete going plant, and are all expenses that a new enterprise must needs incur.

The United States Supreme Court has not as yet been called upon to analyze the costs of operation and to decide what items of cost of operation ought to be included in the annual charges before the profit can be ascertained. Professor Wyman has dealt with

the subject in a satisfactory way [1] and the scope of this article does not call for its further discussion.

The question presented by a schedule of rates under the Fourteenth Amendment is whether the schedule permits a fair return upon a reasonable valuation or is so low as to amount to confiscation. This involves different considerations from those involved when the only question is the propriety of the rate on a single article. It cannot be foretold what effect a change of certain rates, for example on coal or gas, will produce on the net revenue of the business as a whole. This difficulty has been met by the adoption of a tentative course, leaving it for time and experience to determine whether constitutional rights have been infringed.[2]

A most serious difficulty is presented by our dual form of government. It is beyond the scope of the present discussion to treat the numerous cases dealing with the commerce clause, and the question what is interstate and what is intrastate commerce. The net return to a railroad company, — and it is to railway traffic that the questions most frequently relate, — depends on the relation between its income from whatever source derived and its outgoes whether for the conduct of interstate or intrastate business. The two are inextricably intermingled, and the problem of preserving the rights and powers of both the state and the federal governments is one of the problems of the future.

FRANCIS J. SWAYZE.

SUPREME COURT
OF NEW JERSEY.

[1] Wyman on Public Service Corporations, § 1150 ff.

[2] Willcox v Consolidated Gas Co 212 U. S 19, Northern Pacific R'y v. North Dakota. 216 U. S. 579